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Insight!

Bitcoin – A New Asset Class? - Part 1 of a 2 Part Series

Last year, 2020, marked 12 years since Satoshi Nakamoto, the presumed pseudonymous person or persons who developed Bitcoin, published a paper entitled 'Bitcoin a peer-to-peer Electronic Cash System'. In the decade-plus since, the crypto asset market has gone through all the usual phases of a disruptive technology, in massive bull runs, devastating pullbacks, periods of euphoria and deep despair. Along with these stages are the FOMO (fear of missing out), fear and all the emotions in between.

As the Bitcoin enters its second decade, one thing is quite clear and that is Bitcoin, other cryptocurrencies and blockchains are not going away. Today, crypto assets boast a combined market cap in excess of $900 billion[1]; major financial institutions, such as Fidelity Investments and CME Group are now heavily involved; large endowments as for Harvard University, Yale University, and Stanford University, are investing alongside such hedge fund legends as Paul Tudor Jones II. The crypto efforts of major companies, such as Tesla, Facebook, PayPal, Visa, and Square, are frontpage news; and central banks, from the US Federal Reserve to the People's Bank of China even our Bank of Jamaica, are discussing how to develop blockchain-enabled digital currencies of their own.

Despite all the excitement, however, significant challenges remain for investors approaching the market. For starters, the quality of information is poor. Even such basic data as accurate trading volume are hard to come by. Theories about the drivers of crypto-asset valuations are untested and often poorly designed, and they are rarely, if ever, published in peer-reviewed journals. Due diligence efforts from leading consultants are in their infancy stage, and few people have carefully thought through the role (if any) that crypto assets should have in a professionally managed portfolio. More fundamentally, few people even understand what a crypto asset really is or why it matters. Increasingly however, people are deciding that now is the time to start answering the question of the role bitcoin can play in a portfolio. But Why? Well, last year Bitcoin's price appreciated by more than 300% and since the start of this year, has already jumped over 50%. Unsurprisingly, as is the case with many financial assets, Bitcoin gets the attention of speculators and the media after large price surges. For financial advisers, the reason it is getting attention is that clients are asking. For central bankers, it is because crypto and blockchains threaten to disrupt their markets. And for professional investors, it is because the returns and low correlations that crypto assets, such as Bitcoin, offer at this point are becoming hard to ignore.

The first publicly available trading data for Bitcoin goes back to July 2010, when Bitcoin was trading at about US$0.05 per coin. As of December 31, 2020, Bitcoin traded at roughly US$28,996, meaning a US$100 investment in the crypto asset on its first trading in 2010, would have been worth approximately US$58 million at the end of 2020.

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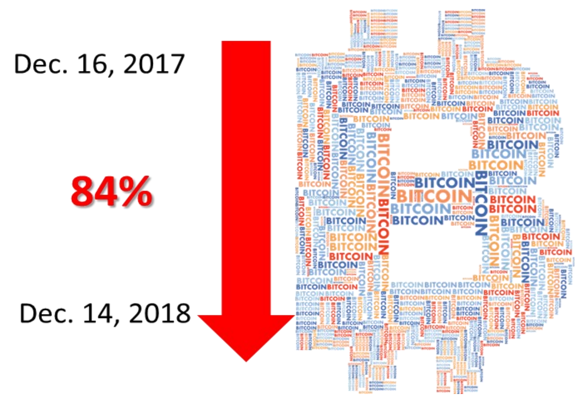
[1] https://www.visualcapitalist.com/bitcoin-market-cap-compared-to-crypto/

Perhaps the easiest way to visualize the historical performance of Bitcoin is to review the performance on a segmented calendar basis as in the Table 1 below. As the data has shown, Bitcoin has risen in nine (9) of the eleven (11) calendar years since its traded prices have been available and has posted triple digit returns or greater in seven of those years. These phenomenal returns make Bitcoin the best performing investment over the last decade and arguably at this point, the best ever performing publicly available investment.

Table 1. BITCOIN'S QUARTERLY AND CALENDAR-YEAR RETURNS, 17 JULY 2010–30 SEPTEMBER 2020

Year	Q1	Q2	Q3	Q4	CY
2010			25.03%	384.65%	505.94%
2011	161.54%	1952.74%	-68.08%	-8.16%	1473.76%
2012	4.03%	36.53%	84.59%	9.12%	186.08%
2013	604.58%	2.23%	43.02%	447.24%	5537.40%
2014	-40.31%	41.03%	-39.58%	-16.92%	-57.74%
2015	-24.00%	7.55%	-10.18%	82.17%	33.74%
2016	-3.33%	61.73%	-9.25%	58.44%	124.81%
2017	11.48%	127.63%	77.29%	222.10%	1349.04%
2018	-50.67%	-7.69%	3.40%	-44.17%	-73.71%
2019	11.14%	174.40%	-26.28%	-13.74%	93.95%
2020	-9.36%	41.12%	17.21%	170.81%	316.57%

These high returns, however, have been accompanied by high volatility, whether measured on an intraday, daily, annual, or peak-to-trough basis. As Table 1 shows, Bitcoin has experienced fifteen (15) negative-return quarters since its inception, along with two negative years, including the 74% pullback in 2018. Outside of the segmented calendar periods, Bitcoin's price has gone through six different peak-to-trough drawdowns of more than 70% since inception. The most major pullback occurred after Bitcoin hits its all-time daily closing price of US$19,396 on December 16, 2017. From that point, the price of Bitcoin retreated rapidly until bottoming on December 14, 2018, when it traded for $3,177 for a drawdown of 84%.



An important characteristic of Bitcoin's historical returns, especially for portfolio managers, is that they have exhibited consistently low correlations with the returns of most major assets. Probably this should not have been surprising as Bitcoin remains an early-stage investment opportunity, and the core drivers of Bitcoin's value are distinct from the core drivers of other assets. Stocks, for example, are primarily driven by corporate profits, economic growth and interest rates while Bitcoin's value is driven by market adoption, network security, liquidity, inflation risks, supply changes, regulatory developments, technological developments and other factors.

Therefore, Bitcoin can play a role in diversifying a portfolio and has the potential to assist portfolio managers in generating outsized returns. However, the impact of adding various weightings in a portfolio context depends on the period over which the analysis is done. To quantify this, in our next article, we will explore how portfolio managers and investors can use Bitcoin exposure in a portfolio context.